governmental action," (2) the "economic impact of the regulation on the claimant," and (3) the "extent to which the regulation has interfered with distinct investment-backed expectations."[113] The Court has reiterated that three-part test in subsequent decisions.[114] That test is even more likely to indicate a need for compensation in the case of breach of the regulatory contract than in the case of burdensome land-use restrictions, which spawned the rule.

a. The Character of Governmental Action

60. In an opinion for the Federal Circuit in *Loveladies Harbor, Inc.* v. *United States*, Judge Jay Plager described this first of the three *Penn Central* criteria as requiring a court to scrutinize "the purpose and importance of the public interest reflected in the regulatory imposition" and "to balance the liberty interest of the private property owner against the Government's need to protect the public interest through imposition of the restraint."[115] That analysis sounds identical to the means-ends scrutiny of economic regulation that courts employ under the Due Process Clauses of the Fifth and Fourteenth Amendments. Implicitly, that means-end analysis takes place at the level of minimum-rationality review. As Judge Plager noted, the Court has considered whether "the avowed need of the Government" to protect some "interest of the public" is indeed "a legitimate interest"[116] and whether "the method of attaining the sought-after goal was reasonably designed to attain it."[117]

61. Presumably, if the regulation were deficient in either respect (a tall order under minimum rationality), then the regulation would not be a valid exercise of the police power, and compensation would be due the property owner. At the same time, of course, the regulation in question would be invalid on due process grounds. If, as is more likely, the regulation survived review under that minimum rationality standard, the takings analysis would proceed to consideration of *Penn Central*'s other two criteria.

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113. 438 U.S. 104, 124 (1978) (citation omitted); *accord, Lucas*, 112 S. Ct. at 2893; Loretto *v.* Teleprompter Manhattan CATV Corp., 458 U.S. 419, 426 (1982).

114. *E.g.*, Kaiser Aetna *v.* United States, 444 U.S. 164, 175 (1979); PruneYard Shopping Center *v.* Robins, 447 U.S. 74, 83 (1980).

115. 28 F.3d 1171, 1176 (Fed. Cir. 1994).

116. *Id.* (citing Ruckelshaus *v.* Monsanto Co., 467 U.S. 986, 1014 (1984)).

117. *Id.* (citing Nollan *v.* California Costal Comm'n, 483 U.S. 825, 837 (1987)).

b. The Economic Impact of the Regulation on the Claimant

62. This second criterion of *Penn Central* can be seen as a requirement to minimize the transactions costs of takings claims, along the lines of Justice Holmes' remark in *Pennsylvania Coal* that government "hardly could go on" if made to compensate every diminution in value arising from its regulation.[118] In *Loveladies* Judge Plager imputed just such a meaning to Justice Holmes' remark.[119] Below a certain cutoff, it would seem, an uncompensated diminution in property value arising from a change in regulation should not consume the resources of the government (as defendant) and the courts. That reasoning is analogous to the requirement that a party plead a minimum amount in controversy to establish jurisdiction.

63. Interestingly, Judge Plager reasoned in *Loveladies* that *Penn Central*'s overriding requirement—that the payment of compensation for a regulatory taking was conditioned on the property owner's showing that the government had denied him "economically viable use" of his property—was just another way of expressing the idea embodied in *Penn Central*'s second criterion concerning the economic impact of the regulation on the claimant.[120] In Judge Plager's words, both articulations expressed the same "threshold requirement that the plaintiff show a serious financial loss from the regulatory imposition."[121]

c. Interference with Distinct Investment-Backed Expectations

64. The remaining criterion in the *Penn Central* test—interference with distinct investment-backed expectations—does all the heavy lifting in a regulatory takings case. If the government has used its police power in a reasonable manner for a legitimate purpose, and if the regulation has diminished the value of private property by a nontrivial amount, then the remaining question is whether the property owner himself has absorbed that diminution or whether he already contracted to accept the diminution if and when it occurred. Again, Judge Plager's formulation in *Loveladies* is particularly lucid.

65. The requirement that the property owner establish his distinct investment-backed expectations is "a way of limiting takings recoveries to owners who could demonstrate that they bought their property in

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118. 260 U.S. at 413.
119. 28 F.3d at 1176–77.
120. *Id.* at 1177 (citing Agins *v.* Tiburon, 447 U.S. 255, 260 (1980); *Nollan*, 483 U.S. at 834).
121. *Id.*

reliance on a state of affairs that did not include the challenged regulatory regime."[122] Judge Plager elaborated: "In legal terms, the owner who bought with knowledge of the restraint could be said to have no reliance interest, or to have assumed the risk of any economic loss. In economic terms, it could be said that the market had already discounted for the restraint, so that a purchaser could not show a loss in his investment attributable to it."[123]

66. To that analysis of risk bearing, one can add a related point: The requirement is a means to impose a system of falsifiability on what could otherwise become an inherently subjective inquiry. Without the requirement that the property owner objectively prove, through evidence of investment, that he detrimentally relied on the challenged regulatory regime, how could a court really know whether the regulation at issue had diminished *this person's* wealth at all? Specious claims of lost property value would otherwise inundate the state. That further explanation comports with the Court's observation in *Ruckelshaus* v. *Monsanto Co.* that "[a] 'reasonable investment backed expectation' must be more than 'a unilateral expectation or an abstract need,'"[124] and its statement in *Usery* v. *Turner Elkhorn Mining Co.* that "legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations."[125] A private party may have expectations that are, objectively speaking, unreasonable. The Court, not surprisingly, has delivered more guidance on what are *not* reasonable investment-backed expectations than what are.[126]

2. The ILEC's Investment-Backed Expectations

67. If analyzed as a regulatory taking, the problem of stranded costs is far more compelling than the typical case of land-use restrictions. The overriding purpose of the regulatory contract is to induce the utility to make specialized investments. By accepting its franchise, the ILEC undertakes an obligation to

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122. *Id.*

123. *Id.*

124. 467 U.S. 986, 1005–06 (1984) (quoting Webb's Fabulous Pharmacies *v.* Beckwith, 449 U.S. 155, 161 (1980)), *quoted in Loveladies*, 28 F.3d at 1177.

125. 428 U.S. 1, 16 (1976).

126. Concrete Pipe & Prods. of Cal., Inc. *v.* Construction Laborers Pension Trust for S. Cal., 113 S. Ct. 2264, 2291–92 (1993); Connolly *v.* Pension Benefit Guaranty Corp., 475 U.S. 211, 226–27 (1986).

serve—that is, to provide service to any and all customers in its service territory. The ILEC further agrees to abide by a host of regulations that determine its prices, product offerings, investments, and accounting procedures. Most important, the ILEC must make long-term investments in highly specialized, immovable facilities. The regulatory contract exists to create the institutional structure of incentives and credible assurances for the utility to undertake the substantial capital costs required to perform its service obligations. Without those credible assurances, an ILEC would not have been willing to incur capital costs to build the facilities needed to satisfy regulatory obligations to serve.

B. Physical Invasion of Property and Its Relation to Mandatory Access to the Utility's Premises, Rights of Way, and Network Facilities

68. In contrast to regulatory takings, government policies that effect physical invasions of property elicit the greatest judicial protection of private property. A physical invasion of property compelled by the government gives rise to an absolute right of compensation.

1. The *Loretto* Decision

69. The leading decision on takings arising from physical invasion of property is the Supreme Court's 1982 decision in *Loretto* v. *Teleprompter Manhattan CATV Corp.*, which defended that rule even in the case of "a minor but permanent physical occupation of an owner's property authorized by government."[127] The Court announced that "when the 'character of the governmental action,' is a permanent physical occupation of property, our cases uniformly have found a taking to the extent of the occupation, without regard to whether the action achieves an important public benefit or has only minimal economic impact on the owner."[128]

70. At issue in *Loretto* was a New York statute that required a landlord to permit a cable television (CATV) company to install its CATV facilities upon her property, subject to payment of no greater than "reasonable" compensation set by a state commission. Exclusively franchised to build the CATV system within certain parts of Manhattan, Teleprompter wired Ms. Loretto's five-story apartment building, for which

127. 458 U.S. 419, 421 (1982).
128. *Id.* at 434–35 (quoting *Penn Central*, 438 U.S. at 124) (citation omitted).

the commission deemed her to be entitled to a one-time payment of one dollar. The motivation for the statute is clear: Before enactment of the statute, Teleprompter routinely paid a property owner 5 percent of the gross revenues received from having access to his property.[129] The statute gave Teleprompter a way to pay a lower price for such access.

71. Teleprompter's physical invasion of Ms. Loretto's building was minor and consisted of a cable "slightly less than one-half inch in diameter and of approximately 30 feet in length along . . . the roof top," two directional taps on the front and rear of the roof that were four-inch cubes, "two large silver boxes along the roof cables," and the screws, nails, and bolts used to attach those various pieces of infrastructure to the building.[130] (Actually, two buildings were involved, but I have simplified the facts here.) Plainly, what motivated Ms. Loretto was not the obtrusiveness of Teleprompter's physical occupation of her property, but rather her opportunity cost (in terms of forgoing a 5 percent share of CATV subscription revenues generated by her tenants) upon being compelled to grant access to her property essentially for free.

72. Although *Loretto* was in practical terms a simple case of access pricing, the Court chose to make the fact of physical invasion dispositive.[131] Referring to one of *Penn Central*'s three criteria, Justice Marshall wrote for the majority that "when the physical intrusion reaches the extreme form of a permanent physical occupation, . . . 'the character of the government action' not only is an important factor in resolving whether the action works a taking but also is determinative."[132] A physical intrusion by government has "unusually serious character" and, if permanent, is "extreme" and fundamentally different from a temporary physical intrusion.[133] "When faced with a constitutional challenge to a permanent physical occupation of real property, this Court has invariably found a taking."[134] Professor Frank Michelman of Harvard Law School, the Court concluded, "accurately summarized" the law on physical invasions of property in his classic article:

> The modern significance of physical occupation is that courts . . . *never* deny compensation

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129. *Id.* at 423.
130. *Id.* at 422.
131. *Id.* at 426 ("a permanent physical occupation authorized by government is a taking without regard to the public interests that it may serve").
132. *Id.*
133. *Id.*
134. *Id.* at 427–28.

> for a physical takeover. The one incontestable case for compensation (short of formal expropriation) seems to occur when the government deliberately brings it about that its agents, or the public at large, 'regularly' use, or 'permanently' occupy, space or a thing which theretofore was understood to be under private ownership.[135]

Unlike the balancing analysis in a regulatory takings case, "a permanent physical occupation is a government action of such a unique character that it is a taking without regard to other factors that a court might ordinarily examine."[136] The Court likened its rule on permanent physical invasion to a per se rule in antitrust law.[137]

73. Under *Loretto*, the physical magnitude of the invasion of property does not matter. The Court said that "constitutional protection for the rights of private property cannot be made to depend on the size of the area permanently occupied."[138] The Court made light of the factual disagreement between the majority and the dissenters over the volume of the cable boxes attached to Ms. Loretto's building. "The displaced volume . . . . [is] not critical: whether the installation is a taking does not depend on whether the volume of space it occupies is bigger than a breadbox."[139]

74. Writing for the majority, Justice Marshall reasoned that a government policy permitting the permanent physical occupation of private property without compensation would be harmful to society as a matter of first principles, and that such considerations animated the precedents upon which the Court relied in *Loretto*. "Property rights in a physical thing," he reasoned, are "the rights 'to possess, use and dispose of it,'" and the government's permanent physical occupation of private property "destroys each of these rights."[140] Justice Marshall noted in particular that "the owner has no right to possess the occupied space himself, and also has no power to exclude the occupier from possession and use of the space. The power to exclude has traditionally been considered one of the most treasured strands in an owner's bundle of property rights."[141] A powerful economic rationale supports that conclusion, for the power to exclude is a prerequisite to voluntary exchange, allocative efficiency, and investment. The Court further noted that "the permanent

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135. *Id.* at 427 n.5 (quoting Frank Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1184 (1967) (emphasis in original)).

136. *Id.* at 432.

137. *Id.* at 436.

138. *Id.* at 436 n.12.

139. *Id.* at 438.

140. *Id.* at 435 (quoting United States *v.* General Motors Corp., 323 U.S. 373, 378 (1945)).

141. *Id.* at 435-36 (citing *Kaiser Aetna*, 444 U.S. at 179-80; RESTATEMENT OF PROPERTY § 7 (1936)).

physical occupation of property forever denies the owner any power to control the use of the property; he not only cannot exclude others, but can make no nonpossessory use of the property. Although deprivation of the right to use and obtain a profit from property is not, in every case, independently sufficient to establish a taking, it is clearly relevant."[142] The Court emphasized that "an owner suffers a special kind of injury when a stranger directly invades and occupies the owner's property."[143]

75. Five years after *Loretto*, the Court considered a similar case. The Pole Attachments Act authorized the FCC to regulate the rates, terms, and conditions of the attachment of cable television wires to utility poles if the state did not engage in such regulation, but the statute (at that time) did not mandate access.[144] An electric utility challenged the statute as a permanent physical invasion of private property, but the Court ruled in *FCC* v. *Florida Power Corp.* that *Loretto* did not apply.[145] Justice Marshall, again writing for the majority, reasoned that the statute merely regulated prices in consensual transactions. Unlike the New York statute in *Loretto*, which contained the "element of required acquiescence . . . at the heart of the concept of occupation," the federal law did not compel the property owner to submit to an involuntary transaction.[146] In 1992 the Court reinforced that rationale: Property owners who "voluntarily open their property to occupation by others . . . cannot assert a per se right to compensation based on their inability to exclude particular individuals."[147] These subsequent decisions do not make *Loretto* any less applicable to mandatory network unbundling, for such regulatory actions are by definition not voluntary. Mandatory unbundling, if unaccompanied by the simultaneous lifting of incumbent burdens and the imposition of a mechanism to recover the full cost of an ILEC's prudent investments to discharge its obligation to serve, would constitute a taking under *Loretto*. If the separations rules were revised in a manner that thwarted such cost recovery, a taking would result.

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142. *Id.* at 436 (citing Andrus *v.* Allard, 444 U.S. at 66) (citation omitted).
143. *Id.*
144. Pub. L. No. 95-234, § 6, 92 Stat. 35 (1978) (codified at 47 U.S.C. § 224).
145. 480 U.S. 245 (1987).
146. *Id.* at 252.
147. Yee *v.* Escondido, 503 U.S. 519, 531 (1992).

2. Mandatory Interconnection or Unbundling

76. Because of the technological and economic complexity of interconnection and unbundling in the telecommunications industry, it is easy to overlook the obvious: Mandatory interconnection and unbundling constitute a government-ordered, physical invasion of the property of the incumbent utility. Mandatory interconnection or unbundling envisions rivals of the regulated firm having physical access to its property. The Oregon Supreme Court has recognized that fact and, relying upon *Loretto*, held unanimously in 1995 that the state PUC's order that enhanced service providers be allowed to co-locate their equipment on the premises of incumbent local exchange carriers constituted a physical invasion that violated the Takings Clause.[148] The court emphasized that "the facts that an industry is heavily regulated, and that a property owner acquired the property knowing that it is heavily regulated, do not diminish a physical invasion to something less than a taking."[149]

77. It is possible for a physical invasion of the incumbent utility's property to occur even when the physical occupation is not visible. The first questions of interconnection pricing in modern regulatory experience arose in connection with the sale of "trackage rights" in the railroad industry. By order of the Interstate Commerce Commission, railroad *A* would be allowed to purchase the right to move its trains over tracks owned by railroad *B*, thus extending the geographic reach of railroad *A*'s rail network beyond its own facilities.[150] One can scarcely imagine a more vivid example of physical invasion than freight trains barreling down a stretch of track. In telephony networks, the locomotives are electrons and photons. Like the locomotive operating pursuant to trackage rights, a rival's use of the incumbent LEC's network involves occupying the physical capacity of that infrastructure to deliver a service that competes with the incumbent's.

78. Finally, it does not matter that the party making the physical invasion of the utility's network is a private company rather than the state itself. As the Court said in *Loretto*: "A permanent physical

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148. GTE Northwest, Inc. *v.* Public Util. Comm'n of Ore., 321 Ore. 458, 468–77, 900 P.2d 495, 501–06 (1995), *cert. denied*, 116 S. Ct. 1541 (1996).

149. 321 Ore. at 474, 900 P.2d at 504.

150. *See* WILLIAM J. BAUMOL & J. GREGORY SIDAK, TOWARD COMPETITION IN LOCAL TELEPHONY 95–96 (MIT Press & AEI Press 1994).

occupation authorized by state law is a taking without regard to whether the State, or instead a party authorized by the State, is the occupant."[151]

C. Uncompensatory Regulation of Public Utility Rates

79. Sandwiched between the strict protection of private property in cases of physical invasions and the minimal protection in cases of regulatory takings are the cases involving the setting of rates for regulated public utilities. Just as property rights are an essential element of private exchange, so also are they required for individuals to transact with the government. Constitutional protections of property rights and due process are the foundation for the administrative process of regulation.

80. Private property protection is the basis for utility regulation. The regulatory contract is subject to the full property protections of the Takings Clause.[152] As explained earlier, an investor-owned utility has a public mandate or obligation to provide service to all in a community who desire such service. In fulfillment of that duty, and in reasonable anticipation of future requests for increased service, the utility purchases and employs specialized assets. Without adequate compensation, the utility will not seek to make investments for expansion or replacement of plant and property and will not be able to raise the necessary capital. Rate regulation controls the returns to investment by the utility's owners; such regulation affects the property's value and therefore must not be confiscatory.[153] The rate of return allowed on property used for public purposes must be sufficient to compensate investors.[154] Sufficiency is measured relative to rates that enable the regulated utility "to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risk assumed."[155]

1. The *Duquesne* Test of Fair Return on Prudently Incurred Investment

81. A taking occurs if regulatory authorities interfere with the utility's opportunity to earn a fair

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151. 458 U.S. at 432 n.9. For a discussion of the physical properties of occupancy of telecommunications networks, see SIDAK & SPULBER, *supra* note 11, at 237–40.

152. Chang *v.* United States, 859 F.2d 893, 894 (Fed. Cir. 1988) ("There is no question that 'valid contracts are property, whether the obligor be a private individual, . . . or the United States.'") (quoting Lynch *v.* United States, 292 U.S. 571, 579 (1934)).

153. Covington & Lexington Turnpike Road Co. *v.* Sandford, 164 U.S. 578, 597 (1896) ("a rate that is too low can 'destroy the value of [the] property.'").

154. Duquesne Light Co. *v.* Barasch, 488 U.S. 299, 308 (1989); Smyth *v.* Ames, 169 U.S. 466, 546 (1898).

155. Federal Power Commission *v.* Hope Natural Gas Co., 320 U.S. 591, 605 (1944).

return on prudently incurred investment to carry out regulatory obligations. Because the state regulates the return that the utility can earn, courts have long considered rate regulation of a utility's property to be subject to the Takings Clause. Uncompensatory rate regulation thus requires compensation of the utility's investors for their forgone expected returns. The major takings cases involving regulated utilities, such as *Hope* and *Duquesne*, do not clearly answer the question of whether the regulator's refusal to allow the utility the opportunity to recover stranded costs is a taking, for those decisions did not address the consequences of deregulation and wholesale abrogation of the regulatory contract in the name of establishing a competitive marketplace. Clearly, the Commission's review of the separations process is made in the context of the sweeping regulatory change envisioned by the Telecommunications Act of 1996.[156]

82. In *Duquesne*, the Duquesne Light Co. began making investments in new nuclear power plants. (Several other utilities were involved in *Duquesne*, but for simplicity I refer only to Duquesne.) Those investments were reasonable (prudent) in light of the current costs of different production technologies and expected future demand at the time they were made. Changes in the relative costs and risks of nuclear power (for example, the Three Mile Island nuclear mishap) resulted in a further (prudent) decision to abandon the nuclear power plants. Duquesne had spent roughly $35 million in planning and preparation by that time.[157] Duquesne sought to add those sunk costs to its rate base and to recover them through amortization and the allowed rate of return. Unfortunately for Duquesne, however, Pennsylvania enacted legislation after the expenditure but before the inclusion of the nuclear costs in the rate base that foreclosed the Pennsylvania Public Utility Commission from granting Duquesne recovery of those costs though higher utility rates.[158] The Court examined whether the state legislation caused a taking of the property of Duquesne's shareholders without just compensation.

83. Writing for the Court, Chief Justice Rehnquist noted that Duquesne had "a state statutory duty to serve the public" and that its "assets are employed in the public interest," but that the company was "owned

156. *Separations Notice* ¶ 2.
157. 488 U.S. at 302.
158. *Id.* at 303–04.

and operated by private investors."[159] Those characteristics set the regulated firm apart from others: "This partly public, partly private status of utility property creates its own set of questions under the Takings Clause of the Fifth Amendment."[160] Whether the allowed rates of a public utility violate the Takings Clause depends on whether they are "confiscatory."[161] That determination, the Court in 1898 admitted in *Smyth* v. *Ames*, is "always . . . an embarrassing question."[162] The answer to that question, however, does not depend on the use of any single methodology. The *Duquesne* Court reaffirmed the holding in *Hope* that it is the overall effect of rate regulation, not the details or methods, that matter:

> [I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.[163]

The question in *Duquesne* then was whether the rate of return that was achieved was constitutionally sufficient. The Court considered the unrecovered sunk costs as part of the investment on which to measure the overall rate of return.

2. Distinguishing Stranded Costs from the Unrecovered Prudently Incurred Investment in *Duquesne* That Did Not Constitute a Taking

84. Five facts convinced the Court that no taking of Duquesne's property had occurred. Those facts look very different in the case of breach of the regulatory contract. First, Duquesne did not claim "that the total effect of the rate order arrived at . . . is unjust or unreasonable," and, to the contrary, the Court found that "the overall effect is well within the bounds of *Hope*, even with total exclusion" of the prudently incurred costs for the nuclear plants.[164] "The Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by countervailing factors in some other aspect."[165] In contrast,

159. *Id.* at 307.
160. *Id.*
161. *Id.* at 307–08 (citing Covington & Lexington Turnpike Road Co. *v.* Sandford, 164 U.S. 578, 597 (1896); Federal Power Commission *v.* Natural Gas Pipeline Co., 315 U.S. 575, 585 (1942); Federal Power Commission *v.* Texaco Inc., 417 U.S. 380, 391–92 (1974)).
162. *Id.* at 308 (quoting 169 U.S. 466, 546 (1898)).
163. *Hope*, 320 U.S. at 602, *quoted in Duquesne*, 488 U.S. at 310.
164. *Id.* at 311–12.
165. *Id.* at 314.

the total exclusion of stranded costs could bankrupt certain utilities.

85. Second, Duquesne's "$35 million investment in the canceled plants comprises roughly 1.9% of its total base."[166] Although the Court here did not cite Justice Holmes's remark in *Pennsylvania Coal* about the transactions costs of compensating trivial takings of private property,[167] that consideration may have been present. In contrast, the amount of stranded costs at stake for an incumbent LEC may exceed the $35 million in *Duquesne* by orders of magnitude.

86. Third, the denial of cost recovery caused by the opportunistic behavior of the Pennsylvania legislature did not threaten Duquesne's survival:

> No argument has been made that these slightly reduced rates jeopardize the financial integrity of [Duquesne], either by leaving [it] insufficient operating capital or by impeding [its] ability to raise future capital. Nor has it been demonstrated that these rates are inadequate to compensate current equity holders for the risk associated with their investments under a modified prudent investment scheme.[168]

Again, breach of the regulatory contract unquestionably *does* jeopardize the financial integrity of incumbent local exchange carriers.

87. A fourth and related fact upon which the Court relied was that the opportunism exercised by the Pennsylvania legislature was not the most extreme version available to it, given the extent to which a public utility's income depended on the consistency of the rate methodology that its regulator employed:

> The risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks. Consequently, a State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions. But the instant case does not present this question.[169]

Justice Scalia, joined by Justices O'Connor and White, concurred but warned, more forcefully than did Chief Justice Rehnquist's opinion for the majority, that the holding in *Duquesne* would not answer the question of whether just compensation would be due in future takings cases where the nature and magnitude of the utility's

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166. *Id.* at 312.
167. 260 U.S. at 413.
168. 488 U.S. at 312.
169. *Id.* at 315.

prudent investment differed substantially from Duquesne's:

> [W]hile "prudent investment" (by which I mean capital reasonably expended to meet the utility's legal obligation to assure adequate service) need not be taken into account as such in ratemaking formulas, it may need to be taken into account in assessing the constitutionality of the particular consequences produced by those formulas. We cannot determine whether the payments a utility has been allowed to collect constitute a fair return on investment, and thus whether the government's action is confiscatory, unless we agree upon what the relevant "investment" is. *For that purpose, all prudently incurred investment may well have to be counted.* As the Court's opinion describes, that question is not presented in the present suit, which challenges techniques rather than consequences.[170]

Breach of the regulatory contract *does* present the serious constitutional question that *Duquesne* did not, for it threatens to exploit the utility's irreversible investment to a far greater extent than does the opportunistic disallowance of costs through prudency reviews or other retrospective mechanisms.

88. Fifth, the Court understood that "utilities are virtually always public monopolies . . . relatively immune to the usual market risks."[171] New policies mandating network unbundling, however, would overturn that understanding, for the goal of such policies is to deny current providers of local telephony service all protection from the "usual market risks" of competition.

89. In short, although *Duquesne* forced utility investors to bear the losses from unrecovered but prudently incurred investments in nonsalvageable assets, the Court's reasoning indicates that the problem of stranded costs arising from breach of the regulatory contract would present a case distinguishable from *Duquesne* in all five respects.

90. An important implication of *Duquesne* is that utility investors must be compensated in one way or another for prudently incurred sunk costs. One possible method is to include the costs in the investment rate base. Another possible method is to increase the future allowed rate of return to be sufficiently above the cost of capital that the effect is as if the cost of capital had been allowed on all investments, including sunk cost losses. Another approach is to have increased the allowed rate of return at the time of investment in order to anticipate the possibility that stranding of investment may occur. What is *not* permitted is switching "back and forth between methodologies in a way which required investors to bear the risk of bad

170. *Id.* at 317 (Scalia, J., concurring) (emphasis added).
171. *Id.* at 315.

investments at some times while denying them the benefit of good investments at others."[172] The Court indicated that sunk costs should be paid by the ratepayers either by explicitly including the investments in the rate base (or by allowing an on-going rate of return sufficiently high that the economic effect is equivalent to including costs in the rate base) or on an ex ante basis where the allowed rate of return has been increased to compensate for the expected cost of stranding.[173] Otherwise, ratepayers must pay the costs of sunk costs when they occur, since investors were not compensated beforehand.

91. Property protections influence the incentives that utilities and ratepayers have to achieve the economically efficient result. If ratepayers bear prudently incurred sunk costs, they will lobby for abandonment of investments only when the economic value of alternative uses for the asset exceeds the value of the asset's continued use by the utility. That is precisely the efficient result. In contrast, investor-borne prudently incurred sunk costs result in inefficiency because the regulatory commission will be tempted to free ride by confiscating the property of the regulated utility.[174] That danger is particularly acute in the "endgame" that occurs in the transition from regulation to a competitive market.

VI. To Prevent Regulatory Opportunism, the Costs of Interconnection Must Be Assigned to the State Jurisdiction

92. The separations process was a decision jointly made by the states and the federal government to advance shared political goals concerning the structure of rates. As such, it was a modification in each state of the regulatory contract, described in part I, to which that state was already a party. The practical effect of the jurisdictional separation of the ILEC's common costs was to interpose the federal government (represented by the FCC) as an additional party to the preexisting contract between the state and the ILEC. The allocation by state and federal regulators of a substantial share of the ILEC's common costs to the interstate side of its books necessarily carried with it several implied, if not explicit, representations: The FCC would afford the

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172. *Id.*

173. *See* A. Lawrence Kolbe, William B. Tye & Stewart C. Myers, Regulatory Risk: Economic Principles and Applications to Natural Gas Pipelines and Other Industries (Kluwer Academic Publishers 1993); A. Lawrence Kolbe & William B. Tye, *The* Duquesne *Opinion: How Much* "Hope" *Is There for Investors in Regulated Firms?*, 8 Yale J. on Reg. 113, 123-27 (1991) [hereinafter *The* Duquesne *Opinion*]; Stephen F. Williams, *Fixing the Rate of Return After* Duquesne, 8 Yale J. on Reg. 159 (1991).

174. *See* Michael J. Doane & Michael Williams, *Competitive Entry into Regulated Monopoly Service and the Resulting Problem of Stranded Costs*, 3 Hume Papers on Pub. Pol'y, No. 3, at 32 (1995).

ILEC the reasonable opportunity to recover, through its sale of interstate services at regulated rates, the entire portion of common costs that had arbitrarily been designated as "interstate" in character; the states would correspondingly allow the ILEC the reasonable opportunity to recover, through its sale of intrastate services at regulated rates, the entire portion of common costs that had arbitrarily been designated as "intrastate" in character; *and* the states and the FCC jointly would ensure that the separations process would enable the ILEC to recover the full amount of common costs, as it would be entitled to do under the original regulatory contract. In short, the sum of the parts may not be less than the whole.

93. Even if one were to assume that the separation process to date has worked flawlessly in the sense that the states and the Commission have honored their joint and several commitments to permit the ILEC full recovery of its common costs as outlined above, it is nonetheless the case that the states and the Commission today lack the ability credibly to make such commitments with respect to the ILEC's recovery of its full common costs of interconnection. Regulatory bodies, like individuals, can tarnish their own reputations. Under Chairman Hundt, the Commission rebuffed, in the *First Report and Order*, arguments by ILECs that the Commission's pricing proposals would deny an ILEC the reasonable opportunity to recover the total costs of providing unbundled network elements and resale.[175] Again, in its *Access Reform Order* in May 1997, the Commission reaffirmed its desire for ILECs to price unbundled access to their networks at TELRIC and stated that the agency would address cost recovery issues in a subsequent order, which never appeared during the remainder of Chairman Hundt's tenure.[176] The Commission must be presumed to intend the foreseeable consequences of its actions. Those actions between August 1996 and the end of Chairman Hundt's tenure suggested that the agency's strategy concerning the pricing of local interconnection had three components:

(1) subsidize competitive entry into local telephony by encouraging (if the Commission could

175. For a detailed discussion of the Commission's regulatory opportunism on interconnection pricing, see SIDAK & SPULBER, *supra* note 11, at 307-92.

176. Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; End User Common Line Charges, First Report and Order, CC Dkt. Nos. 96-262, 94-1, 91-213, 95-72, 12 F.C.C. Rcd. 15,982 ¶ 14 (1997).

not lawfully command) the states to impose prices for unbundled network elements and resale that do not fully compensate the ILEC for its common costs of interconnection,

(2) delay the imposition of any alternative mechanism for cost recovery (such as a competitively neutral, nonbypassable end-user charge, or the securitization of stranded costs now being undertaken by several states with respect to mandatory unbundling of the electric power industry) that might engender political controversy and publicly expose the magnitude of the shortfall in cost recovery owing to the pricing rule urged upon the states by the Commission, and

(3) maintain that, in the meantime, any claim by an ILEC that the Commission has committed a taking of property is unripe for adjudication, either because cost recovery issues will still (someday) be addressed by the Commission or because no confiscation of an ILEC's property could occur until the ILEC is in financially dire straits and had lost appreciable market share to competitive providers of local telephony.

A good shorthand for this apparent strategy is the "shell game," because the promise of cost recovery, like the pea lurking under one of the three walnut shells, is constantly shifted back and forth from one report and order to another through the Commission's prestidigitation.[177] In short, since August 1996 the Commission

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177. It should also be clear that, unlike Houdini, the Commission cannot make common costs disappear by placing a "forward-looking" gloss on the standard definition of *stand-alone cost*—a precise economic term of art that is critical to determining whether one service (or group of services) is subsidizing another. The Commission defines stand-alone cost as "the *forward-looking* cost that an efficient entrant would incur in providing a service or group of services." *Separations Notice* ¶ 27 (emphasis added) (citing *First Report and Order*, 11 F.C.C. Rcd. at 15,854 ¶ 698). *None* of the major texts on industrial organization or regulatory economics of which I am aware includes in its definition of stand-alone cost the modifier "forward-looking." *See* EDWARD E. ZAJAC, POLITICAL ECONOMY OF FAIRNESS 206–07 (MIT Press 1995); BAUMOL & SIDAK, TOWARD COMPETITION IN LOCAL TELEPHONY, *supra* note 150, at 58; DANIEL F. SPULBER, REGULATION AND MARKETS 104 (MIT Press 1989); ROGER SHERMAN, THE REGULATION OF MONOPOLY 83 (Cambridge University Press 1989); Ronald R. Braeutigam, *Optimal Policies for Natural Monopolies*, *in* 2 HANDBOOK OF INDUSTRIAL ORGANIZATION 1289, 1338–39 (Richard Schmalensee & Robert D. Willig eds., North-Holland 1989); SANFORD V. BERG & JOHN TSCHIRHART, NATURAL MONOPOLY REGULATION: PRINCIPLES AND PRACTICE 242–43 (Cambridge University Press 1988); WILLIAM J. BAUMOL, JOHN C. PANZAR & ROBERT D. WILLIG, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE 375–76, 507 (Harcourt Brace Jovanovich 1982; rev. ed. 1988); JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 20 (MIT Press 1988); WILLIAM J. BAUMOL, SUPERFAIRNESS: APPLICATIONS AND THEORY 120–21 (MIT Press 1986); WILLIAM W. SHARKEY, THE THEORY OF NATURAL MONOPOLY 41 (Cambridge University Press 1982).

It is, of course, a truism that all costs are forward-looking. The Commission's insertion of that phrase into the existing definition of stand-alone cost is, however, a significant act of intellectual revisionism because it connotes to the informed reader the Commission's unique method of defining "forward-looking cost" in the *First Report and Order*, 11 F.C.C. Rcd. at 15,848 ¶ 683, a method which violates sound economic analysis and increases the likelihood that an ILEC will be prevented from recovering the total costs that it prudently incurred to provide service to the public. For a thorough discussion exposing the economic fallacies in the Commission's concept of forward-looking cost, see SIDAK & SPULBER, *supra* note 11, at 403–26; Sidak & Spulber, *Givings, Takings, and the Fallacy of Forward-Looking Cost*, *supra* note 1, at 1139–46.

appears consciously to have devised a subtle and highly sophisticated legal and economic strategy of regulatory opportunism that, as part I explained, the regulatory contract exists to prevent.

94. The separations process gives the Commission an additional degree of freedom by which to make a strategy of regulatory opportunism concerning the recovery of an ILEC's common costs of interconnection even more sophisticated and opaque. The Commission observes in the *Separations Notice*: "While a competitive LEC is free to recover costs according to market demand, an ILEC subject to our jurisdictional separations rules may only attempt to recover costs classified as interstate *through charges for interstate services*, and costs classified as intrastate *through charges for intrastate services*."[178] That statement is false as a matter of contract law and takings jurisprudence. As parts II and III showed, the regulatory contract and takings jurisprudence implies that the ILEC is entitled to receive the reasonable opportunity to recover *all* of its common costs. That obligation borne by regulators does not depend on whether the common costs have been divided into two categories labelled "interstate" and "intrastate." As the name implies, common costs are *common* to the overall activities of the ILEC. The arbitrary assignment of X percent of those common costs to services regulated at the state level and Y percent to services regulated at the federal level does not alter in any way the essential commonality of those costs. Nor, in the event that confiscatory rates deny the ILEC full recovery of it common costs, does such a jurisdictional assignment of costs magically limit the states' liability to X percent of the unrecovered common costs and the FCC's liability to Y percent of the unrecovered common costs. The ILEC does not compromise its right to full recovery of its common costs because state and federal regulators happen to choose one allocation formula instead of another. As noted above, the ILEC has the legal right under contract principles and takings jurisprudence for the sum of the jurisdictional parts to equal the whole of the ILEC's common costs of interconnection.

95. If it were not unchecked by the regulatory contract and the Takings Clause, the separations process could have the practical effect of capping the price for service A below its stand-alone cost by virtue of the insufficient amount of common costs jurisdictionally allocated to that service. Meanwhile, the

178. *Separations Notice* ¶ 19 (emphasis added).

separations process may allocate to service *B* a seemingly generous amount of common costs that would imply a price exceeding the stand-alone cost of *B*; yet being granted the regulatory freedom to charge a price exceeding stand-alone cost is worthless to the ILEC, for the market already constrains the ILEC to charge no more than the stand-alone cost of *B*. If such a jurisdictional separation were not accompanied by an independent cost recovery mechanism (such as a competitively neutral, nonbypassable end-user charge or the issuance of transition bonds), the shell game of jurisdictional separations would be complete.[179]

96. The shell game is not merely violative of contract principles and takings jurisprudence. It is also injurious to economic welfare. The *Separations Notice* does not recognize that allocating the costs of interconnection across both the state and federal jurisdictions would increase the likelihood that the rates for interconnection would fail to recover the full cost of interconnection. The Commission regards the separations process as a safeguard against an ILEC's *over*recovery of its costs: "One of the primary purposes of this process is to prevent ILECs from recovering the same costs in both the interstate and intrastate jurisdictions."[180] But the Commission seems not to recognize that *under*recovery of costs is just as serious a threat to consumer welfare. If the separations process has the effect of denying the ILEC recovery of the full amount of costs that it prudently incurred to provide service to the public, then the separations rules will discourage new investment by ILECs in network assets that are subject to the separations process.

97. First principles imply that the federal government and the states would be jointly and severally liable for the taking that will occur if the separations process, applied to interconnection costs, had the practical effect of denying the ILEC a reasonable opportunity to recover all of its common costs. Here it is useful to distinguish between the probable outcome of a legal theory of recovery predicated on the regulatory contract from that of a legal theory predicated on takings jurisprudence. If an ILEC challenged, as a breach of the regulatory contract, the revenue adequacy of a rate order for interconnection, the ILEC presumably would sue both the state government and the federal government for breach, since the efficacy of the separations process upon which both governmental bodies had agreed would be essential to the recovery of

179. For a discussion of transition bonds and the securitization of stranded costs, see SIDAK & SPULBER, *supra* note 11, at 444–47.
180. *Separations Notice* ¶ 3.

common costs. In its defense, the state might assert that, as a constitutional matter, it was compelled by the supremacy of the federal government to acquiesce to the FCC's modification of the regulatory contract. The federal government, in its defense, would presumably claim sovereign immunity, which might or might not shield the federal government from liability, depending on whether or not the Supreme Court's 1996 decision in *Winstar* turns out to constitute a major shift in the Court's view of the enforceability of the federal government's contractual obligations. If sovereign immunity or some similar defense could indeed shield the federal government from liability for breach of the regulatory contract, the state would then bear the full responsibility for compensating the ILEC for its unrecovered common costs. The state might seek indemnification from the federal government, but that claim presumably would have no greater likelihood of success than the ILEC's own contract claim against the federal government, which we have assumed *arguendo* to have been thwarted. Thus, if the FCC were able to defeat a claim for breach of the regulatory contract, it would be because, notwithstanding its participation in the separations process, the agency was able to shift the liability for the recovery of common costs onto the states in which the ILEC in question provided regulated intrastate services.

98. The outcome under a takings theory presumably would be different. The federal government could not escape liability, for the ILEC would bring its claim under the Takings Clause of the Fifth Amendment. The state or states with which the FCC had jurisdictionally separated the common costs of the ILEC in question could also be sued under the federal Takings Clause (as well as under the takings clauses of the applicable state constitutions, which might be even more protective of property).

99. Under either the contract or takings theory, the state would incur liability for an ILEC's underrecovery of its common costs of interconnection if those costs were jurisdictionally separated under Part 36. Given that the federal government may have the practical ability to evade liability for an underrecovery of the ILEC's common costs of interconnection but the state surely would lack that ability,[181] it would only be appropriate to place the burden of cost recovery for interconnection on the states in the first place. The

181. On the relevance of state sovereign immunity to breach of the regulatory contract, see SIDAK & SPULBER, *supra* note 11, at 191–98.

states might hope to see some fraction of the common costs of local interconnection assigned to the ILEC's interstate services; but if competition in the market for those interstate services will not allow prices to exceed long-run incremental cost to any significant extent, then that fraction of common costs will be unrecoverable for the ILEC and will come home to roost, under either contract or takings principles, as the state's own financial liability. It would be more sensible, therefore, to assign to the states exclusively the responsibility of seeing that the regulated prices for interconnection that they set will permit the ILEC to recover all the costs of interconnection or that the ILEC will receive some other meaningful opportunity to recover the totality of those costs.[182]

100. That conclusion from common sense is reinforced by the legal conclusion that the Commission lacks the authority under the Telecommunications Act of 1996 to set prices for interconnection. In July 1997 the U.S. Court of Appeals for the Eighth Circuit issued its decision in *Iowa Utilities Board* v. *FCC*,[183] in which the court vacated the pricing provisions of the FCC's *First Report and Order*. The court held that "the FCC exceeded its jurisdiction in promulgating the pricing rules regarding local telephone service."[184] Accordingly, the court vacated the FCC's pricing rules "on that ground alone" and did not review the rules on their merits.[185]

101. In the exercise of their police power, the states are free to refrain from building the costs of interconnection into the prices of interconnection. As noted earlier, the states in that circumstance simply must afford the ILEC a reasonable opportunity to recover its total common costs through some other equally efficacious mechanism. It would not be a reasonable alternative, however, for the state to assign the ILEC's interconnection costs to its price elastic services (such as centrex). The result would be an allowed regulated price that exceeded the market price for such competitive services.

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182. It is not technically correct, of course, to speak of "*removing* interconnection costs from the separations process," because the separations process today removes *unregulated* costs through Part 64. Interconnection costs and prices are *regulated*. Thus, interconnection costs are subject to the Part 36 process of separating the ILEC's regulated costs. My conclusion that the Joint Board should assign 100 percent of an ILEC's interconnection costs to the state jurisdiction is not equivalent to saying that interconnection costs should be exempted from the separations process altogether.

183. 1997 U.S. App. LEXIS 18183 (8th Cir. July 18, 1997).

184. *Id.* at *7.

185. *Id.* at *34.

102. The Commission notes that the Supreme Court ruled in *Smith v. Illinois Bell Telephone Co.* that "'proper regulation of rates can be had only by maintaining the limits of state and federal jurisdiction' to determine whether rates are confiscatory."[186] What the many frequent citations to that passage seem not to appreciate is that, as noted above, the separations process itself tempts state and federal regulators to act opportunistically through their jurisdictional separation of common costs so as to suppress an ILEC's regulated prices below levels that are fully compensatory. Given the Commission's limited ability to commit itself credibly to a policy of *not* acting opportunistically in this regard, the Joint Board's best option is to assign to the states the common costs of interconnection. The Commission should not require an ILEC to divide its common costs of a service across both the state and federal jurisdictions if only the state has the legitimate authority to set rates for that service.

IV. The Creation of New Accounts for the Costs of Interconnection Is Unnecessary and Would Enable the Commission to Regulate Interconnection Prices Indirectly

103. The Commission "seek[s] comment on the proposed . . . account descriptions"[187] for the costs of interconnection and unbundled network elements and "propose[s] subsidiary recordkeeping categories that will enable carriers to identify the . . . amounts paid for interconnection and each unbundled network element."[188] Later in the *USOA Notice*, the Commission shows how it would restrictively define the ILEC's cost of providing unbundled network elements: "We anticipate that ILECs providing interconnection and access to unbundled network elements will not generate new types of costs *beyond those already being incurred in normal operations*."[189] In other words, the Commission would put on Part 32 its gloss that the process of unbundling is essentially costless to the ILEC. That conclusion is false as a matter of economic reasoning.[190] Next, the Commission proposes "that the total amount of costs to be recorded in the subsidiary

186. *Separations Notice* ¶ 33 (quoting 282 U.S. 133, 149 (1930)).
187. *USOA Notice* ¶ 8.
188. *USOA Notice* ¶ 9.
189. *USOA Notice* ¶ 14 (emphasis added).
190. *See* SIDAK & SPULBER, *supra* note 11, at 414–16.

records be based on the revenues received for providing interconnection."[191] At a matter of elementary economics, however, "the revenues received for providing interconnection" or the "amount paid for . . . each unbundled element network element"[192] will not be the true cost to the ILEC of providing that element or form of interconnection to a competitor if the regulator's accounting measure of cost ignores opportunity cost.[193] Under the aegis of Part 32, the FCC is seeking to tell the states what the TELRIC of a particular network element is, *as the Commission chooses to define it*. Clearly, what the Eighth Circuit has forbidden the Commission to do directly, the agency cannot now do circuitously.

104. Further, the Commission seems to be proposing the tautology that the cost of an unbundled network element is whatever the ILEC receives as revenues for the sale of that element to a competitor—implicitly, at regulated prices. That identity would not be a tautology if the prices for unbundled network elements and resale were fully compensatory as a matter of takings jurisprudence. The fact that those prices are not, however, is the core of the controversy over the pricing of unbundled network access. The Commission would conveniently assume away that problem by presuming that any price that a regulator set for unbundled access would necessarily be compensatory.

105. The Commission's pretext for creating the new Part 32 accounts for interconnection is transparent. Its principal goal is "uniformity in reporting":

> Without guidance from the Commission, carriers could differ regarding into which existing account the revenues and expenses should be recorded. We seek uniformity in reporting to facilitate comparisons among ILECs and to calculate and track investments and performance related to these services.[194]

The Commission then specifically enunciates four goals for its proposed accounts and subsidiary recordkeeping requirements:

> (1) to facilitate uniform reporting among ILECs with respect to interconnection and infrastructure sharing arrangements; (2) to enable the Commission to monitor and assess the economic impact of the development of local exchange and exchange access competition and

191. *USOA Notice* ¶ 9.
192. *USOA Notice* ¶ 9.
193. *See* SIDAK & SPULBER, *supra* note 11, at 322–25; *see also* City of Los Angeles Dep't of Airports *v.* United States Dep't of Transp., 103 F.3d 1027, 1032 (D.C. Cir. 1997).
194. *USOA Notice* ¶ 5 (footnote omitted).

> the deployment of advanced telecommunications capabilities; (3) to ensure that regulated ratepayers do not bear the costs of ILECs' competitive activities; and (4) to assist Commission decisionmaking concerning ILEC petitions for forbearance from regulation pursuant to section 10 of the Act by making information concerning ILEC performance related to these services accessible and verifiable.[195]

Those goals are questionable for five reasons. First, it is far from clear *a priori* that the costs of requiring uniform reporting of ILECs' interconnection costs does not exceed the benefits. One advantage that a competitive market is commonly predicted to have over a regulated one is that firms are not homogeneous, but rather differentiate their products and production processes through experimentation and investments in innovation. The Commission does not explain how the imposition of cookie-cutter cost-reporting requirements for interconnection squares with the intention of Congress to make local telecommunications a competitive marketplace. To the contrary, the Commission simply asserts that "the proposed accounts will provide the Commission with useful information without imposing undue burdens on carriers."[196] A bald assertion is not equivalent to a factual record.

106. Second, the Commission has already provided a striking example of its approach to imposing "uniformity" on the process by which ILECs calculate cost-based prices for interconnection. That example was the federally prescribed rate card of proxy prices that the Commission sought, in the *First Report and Order*, to impose on the states as interim prices for unbundled network elements and resale. Those proxies were centrally planned prices generated from a computer model. Thus, when the Commission says that it wants to "monitor and assess the economic impact of the development of local exchange and exchange access competition and the deployment of advanced telecommunications capabilities," the agency can hardly be surprised that its words engender the suspicion that the agency wants to use its proposed Part 32 accounts to establish benchmark costs of unbundled network access and resale; in turn, interconnection prices computed on the basis of those costs would become a precondition of the FCC's conclusion that local exchange and exchange access competition existed in a given market.

107. Third, the Commission's concern that "regulated ratepayers do not bear the costs of ILECs'

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195. *USOA Notice* ¶ 6.
196. *USOA Notice* ¶ 6.

competitive activities" rings hollow. If the Commission means to suggest that *new* Part 32 accounts are the last line of defense against cross-subsidization, it cannot be taken seriously. The economic factors that make cross-subsidization implausible are well-known in the academic literature and have been presented to the Commission, the Justice Department, and Judge Greene in countless proceedings in the past.[197] It is disingenuous for the Commission in 1997 to toss out vague references to cross-subsidization when discussing the pricing of interconnection, which, since the *First Report and Order*, has been the subject of scores of state arbitration proceedings to establish regulated rates.

108. Fourth, surely the Commission cannot believe that the prices for unbundled network elements and resale will exceed the corresponding measures of stand-alone costs. To the contrary, in the state arbitration proceedings establishing interim rates the real risk was that state commissions would set prices for unbundled network elements that were *below* their TELRICs. The only party receiving a cross-subsidy in that circumstance would be the entrant purchasing unbundled elements.[198]

109. Fifth, the Commission's desire for assistance in "decisionmaking concerning ILEC petitions for forbearance from regulation" does not provide a persuasive basis for creating new cost accounts. To carry the Commission's argument to its absurd conclusion, the agency should impose all sorts of new regulatory burdens on ILECs in the name of making it easier for the FCC to decide whether to forbear from regulating those carriers. It is also not clear why, as an alternative to amending Part 32, it would not suffice for the Commission simply to require that a particular ILEC seeking the agency's forbearance bear the burden of providing the Commission with firm-specific information that was "accessible and verifiable."

110. Despite the Eighth Circuit's ruling, the Commission asserts in its *USOA Notice*:

> We note that the pricing provisions of the *Local Competition Order* have been vacated . . . . Regardless of how prices for interconnection are determined, new Part 32 accounts and subsidiary recordkeeping requirements are necessary to meet the goals set forth in paragraph 6.[199]

To the contrary, the four goals specified in the *USOA Notice* provide no persuasive basis whatsoever for

197. For a summary of the reasoning rebutting the cross-subsidization argument, see SIDAK & SPULBER, *supra* note 11, at 90–96.
198. *See id.* at 307–92, 403–26.
199. *USOA Notice* ¶ 5 n.17 (citation omitted).

adopting as "necessary" the enhanced regulatory burden of new Part 32 accounts for the costs of interconnection. If anything, that statement by the Commission telegraphs the agency's intention to use the proposed new Part 32 accounts as a way of federally regulating the price of unbundled access to the local telecommunications network and/or as a means to wipe prudently incurred costs completely off the ILECs' books by mandating that the "cost" of these unbundled elements and services is whatever the ILEC receives as revenues. If the Commission can so commandeer the definition of "cost" through the arcane and seemingly innocuous step of creating Part 32 accounts for the cost of interconnection and establishing subsidiary recordkeeping requirements, the agency once more can, in effect, insinuate itself into the very midst of the state ratemaking process for interconnection. The Eighth Circuit, however, has made clear that the Commission has no authority to regulate the price of unbundled network access. Therefore, new Part 32 accounts that directly or indirectly serve to regulate the price for unbundled network access are inconsistent with the Eighth Circuit's mandate and should not be adopted.

CONCLUSION

111. As the Joint Board reforms the separations process, it must make explicit, as one of the criteria for designing separations rules, that cost recovery is a necessary consequence of both takings jurisprudence and the regulatory contract. The Takings Clause and the regulatory contract obligate the Commission and the states to ensure that their separations rules give an ILEC a reasonable opportunity to recover all of its costs. In the specific case of interconnection costs, the risk of regulatory opportunism requires that all such costs be assigned to the state jurisdiction. No new categories for interconnection costs are necessary or appropriate to add to Part 32.